

WORK-RELATED DAYCARE

TAX CONSEQUENCES

OF

WORK-RELATED DAYCARE ARRANGEMENTS

BACKGROUND PAPER



THE WORKPLACE DAYCARE
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TAX CONSEQUENCES
OF
WORK-RELATED DAYCARE ARRANGEMENTS

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ARRANGEMENTS

INTRODUCTION AND ACKNOWLEDGEMENTS

This paper is based on Professor Brooks' presentation at a conference on Future Directions in Work-Related Day Care co-sponsored by the Child in the City program at University of Toronto and the Social Planning Council of Metropolitan Toronto in May, 1981. The conference provided the impetus for a number of efforts in this area including the Workplace Daycare Resource Group at the Child in the City program and the Council's Task Force on Work-Related Day Care. It is hoped that these efforts and others like them will be instrumental in the development of an affordable multi-faceted day care system in Canada which will be accessible to all children and families.

The Workplace Daycare Resource Group and the Social Planning Council wish to express thanks to the individuals who put in long hours on the planning committee for the 1981 conference, to the Ministry of Community and Social Services, Ontario, who helped fund this publication and to Neil Brooks, who contributed his time and effort to prepare this paper.

TAX CONSEQUENCES OF WORK-RELATED DAYCARE ARRANGEMENTS

I. INTRODUCTION

This paper reviews the various arrangements for providing work-related daycare and examines the tax consequences of each. For this purpose, the numerous forms that employer-sponsored daycare might take are divided into two categories: those situations in which an employer is involved in the establishment of daycare facilities, and those situations in which an employer subsidizes directly the expenses incurred by employees for daycare received through an existing daycare facility. The tax consequences of the first situation are the most complex and the bulk of the paper is addressed to this situation. The tax consequences to both the employer and the employee are considered.

Obviously, tax consequences should not dictate the type of work-related daycare programme that is undertaken. Like any other fringe benefit, a particular form of work-related daycare should be chosen only after a careful weighing of all the costs and benefits both to the employer and the employees. However, the monetary costs of a particular arrangement will usually be an important consideration and as favourable tax consequences can considerably reduce the cost of a programme, the tax consequences of the various arrangements are important and in some cases might be determinative. At least, other things being equal, the programme ought to be structured to obtain the most beneficial tax treatment for the employer and the employee.

II. TAXABLE BENEFITS AND BUSINESS EXPENSES

An understanding of two basic tax concepts is necessary to appreciate the tax consequences of the various forms of work-related daycare.

a) Taxable Benefits

In determining the net cost of employer-sponsored daycare, the tax consequences to both the employer and the employee must be considered. From the employees' point of view, if their employer has made some provision for daycare, the issue will usually be whether or not an amount has to be included in their income as a taxable benefit. If the employee is paying the fair market value for child care services provided by an employer the issue will not arise: The situation would be no different than the case where the employee purchased the services from a third party. In most cases, some of the expenses will be deductible by one parent under the child care deduction section of the Income Tax Act. However, if the employer subsidizes, either directly or indirectly, the child care expenses of employees, or reimburses them for child care expenses incurred, then the tax question arises as to whether or not the value of the subsidy or reimbursement has to be included in the employees' income as a taxable benefit.

The normal rule is that employees must include in their income for tax purposes the value of all benefits they receive by virtue of their employment, unless such benefits are specifically exempted from tax in the Act or as a matter of administrative practice Revenue Canada does not tax such benefits. The Act provides an exemption from tax for such benefits as employer contributions to registered pension plans, group sickness or accident insurance plans and group term life insurance policies. However, no exemption is provided for an employer's costs relating to the provision of daycare for employees.

Consequently, in determining whether such benefits are taxed one must turn to administrative practice. As Revenue Canada has not yet published its position on the taxation of work-related daycare benefits, one must infer their position from present practices and their treatment of analogous fringe benefits.

Since the question of whether employer subsidized daycare is taxed might depend upon the form in which it is offered, the answer to this question will be addressed below after a discussion of the various forms that such a subsidy might take. Although the Act is not clear on this, presumably if employees do have to include an amount in their income as a taxable benefit because their employer provides subsidized daycare, they should be entitled to claim child care deduction under the Act for this amount to the extent that they otherwise qualify.

It might be noted that employers must also be concerned about whether employees will have to pay tax on the value of work-related daycare benefits. If the value of the benefit is deductible by the employer but not included in the employee's income for tax purposes, it will of course be a preferred form of remuneration. That is to say, it will be one of the few forms of remuneration that an employer can offer an employee that is not taxed in the employee's hands. As such a benefit is considered by Revenue Canada to be a form of wages to employees, in effect, and therefore taxable, the employer will be required to file an information return with Revenue Canada reporting its value and perhaps to include its value in the employee's gross income for the purposes of determining how much must be withheld from the employee's salary and remitted to the Receiver-General of Canada for tax purposes.

b) Employer Business Expenses: Current or Capital

From the employer's point of view, the important questions are whether expenses incurred in providing some form of daycare are deductible for tax purposes and, if so, when? The answer to the first question is straightforward. All expenses which are incurred for a business purpose are deductible. Invariably, it will be easy for an employer to show that all expenses incurred to cover the cost of providing child care for employees were incurred for a business purpose; namely, to reduce the level of absenteeism and employee turnover, to assist employee recruitment, and to raise employee morale and thus productivity.

The more difficult question is relating to the timing of the deduction. Tax law distinguishes between current expenses, which are deductible in the year they are incurred, and capital expenditures, which even though incurred in one year can only be deducted over future years. Employers will normally want to ensure that to the extent possible, any expenses they incur in subsidizing child care are treated as current expenses and are thus deductible in the year in which they incur them. This will provide them with an immediate tax benefit by reducing their tax liability for that year.

Under tax accounting principles, a current expense is one that brings to the business a value that is consumed within the year and capital expenditure is one that produces a benefit which lasts beyond one year. In the context of subsidizing child care expenses, the clearest case of a current expense would be an expense incurred by an employer in reimbursing employees each month for a portion of their child care expenses. The expense provides no lasting benefit to the employer.

The clearest case of a capital expenditure would be an expense incurred by the employer to purchase child-care facilities, furniture or playground equipment. This type of expense will have produced an asset that has a value beyond the current year and thus it will have to be deducted over the life of the assets. The Income Tax Act provides a scheme, called the capital cost allowance system, that provides a somewhat arbitrary but simple method for allowing taxpayers to depreciate (write-off over future years) the cost of capital assets.

In the discussion that follows, the practical consequences of this distinction between current and capital expenses will be elaborated upon in the context of different arrangements for work-related daycare.

III. ARRANGEMENTS THAT INVOLVE THE EMPLOYER ASSISTING IN THE
ESTABLISHMENT OF DAYCARE FACILITIES

For purposes of explaining the tax consequences, the ways in which an employer may be involved in the establishment of daycare facilities can be broken down into four categories.

a) Establishing and operating a daycare facility as part
of the employer's business operations

In this kind of situation, the employer might provide on-site facilities for daycare services, either by erecting a separate premise, or simply converting some part of existing facilities into suitable accommodations. A committee might be established to manage the day-to-day affairs of the centre but since the centre would remain part of the company's overall business operations, it would ultimately retain control over it. If the employer were an incorporated company, the child care services would simply be one aspect of the corporation's business affairs.

In almost all cases where an employer provides child care services under these conditions, employees who take advantage of the service will be charged a fee. The fee will normally be somewhat less than the fair market value of the services for two reasons: (1) the company will often be able to supply some services at less than cost by using company resources, for example, secretarial, janitorial, maintenance or laundry services and by not charging rent for use of the premises; and (2) the company might directly subsidize the centre by operating it at a loss.

From the employer's point of view, the tax consequences of this type of arrangement are relatively straightforward. The corporation's expenses will be treated as any other business expense. The ongoing, day-to-day operating costs, such as salaries, the cost of food, monthly rent, supplies, and other expenses that will be incurred frequently will

be deductible as current expenses. However, the cost of renovations, furniture, appliances, playground equipment, and other assets with an expected useful life of more than one year will be classified as capital expenditures and will have to be amortized. That is to say, those capital costs will have to be deducted over future years according to the rates provided in the capital cost allowance scheme in the Income Tax Act. The cost of furniture, for example, can generally be depreciated at a rate of 20 per cent a year. The cost of renovations would likely have to be added to the cost of the building renovated and in effect, depreciated at a rate of perhaps 5 per cent a year.

To the employee, the tax consequences of this type of arrangement are not clear unless the employee is paying an amount equal to the fair market value of the services provided. If the employee is paying this amount, the only tax consequences will be that he or she will be able to deduct these expenses as provided by the child care expense deduction in the Income Tax Act. The fact that the services are provided by an employer instead of some third party is irrelevant in terms of the tax consequences. However, if the fees do not cover the fair market value of the service - if the employer is subsidizing the services either by not charging the fair market value for services that he or she can provide for less than costs, or by operating the facility at a loss - then employees might have to include some amount for the value of this benefit in their income for tax purposes.

In practice, apparently in many instances of employer-provided subsidized daycare Revenue Canada is not requiring the benefit to be taxed. However, since they have not yet published their views of this subject, employers who provide such services ought to obtain the opinion of Revenue Canada about the taxability of the particular service they are providing. If the provision of the daycare services provided by the employer have the following characteristics, it is unlikely that Revenue Canada would attempt to tax the employees with respect to any benefit:

- (1) The services are available for the use of all employees of the business. If there are only a limited number of spaces for children, they have to be allocated among employees in a manner that does not discriminate against particular classes of employees. Revenue Canada has taken the position with respect to a number of fringe benefits, for example recreational facilities, that if they are provided to all employees of a corporation and not just a special class, such as managers, they will not tax the benefit.
- (2) The services provided do not impose substantial additional costs on the employer. With respect to a number of fringe benefits, if an employer can provide the benefit to employees at little additional cost to itself, Revenue Canada will not tax the benefit.
- (3) The value of the services provided to individual employees are hard to determine. In this situation, instead of assigning an arbitrary value Revenue Canada will often forego tax on the benefit.
- (4) The value of the benefit to the employees is small. In this situation the administrative costs of collecting the tax outweigh the equity gains of taxing the benefits.
- (5) It can be shown that the provision of the benefit serves a valid business purpose. If the benefit is for the convenience of the employer, Revenue Canada is less likely to assign a value for tax purposes to the employees.

- (6) The benefit provided can be shown to be socially desirable. The question of whether a particular fringe benefit is taxable is in part a question of fairness and in part a sociological question. If the provision of work-related daycare can be shown to be an accepted condition of employment, it is less likely that Revenue Canada would attempt to tax its value as a fringe benefit.

If employees have to include an amount in income for tax purposes because they have received employer-subsidized daycare, it is not clear from the Act whether they can claim a deduction for child care expenses, to the extent they would be otherwise entitled. The Income Tax Act provides that a deduction for child care expenses may be made only for "amounts paid by the taxpayer in the year as or on account of child care expenses." Construing the section literally, it could be argued that where taxpayers have to include an amount in their income as a taxable fringe benefit for the provision of employer-subsidized daycare they have not "paid" any amount for child care. On the other hand, in principle, it should not matter whether an amount was actually paid.

Furthermore, the literal reading of the section could easily be satisfied by having an employer actually pay an amount to an employee with children in employer-subsidized daycare and then have the employee pay the amount back to the employer "on account of child care expenses." Presumably, so as not to put form over substance, Revenue Canada will permit employees who have to include the value of employer-subsidized daycare in their income to take the appropriate deduction under the child care expenses deduction provision.

It might be noted that in attempting to establish or in negotiating for fringe benefits like subsidized daycare, employees must balance a number of considerations. For example, if the employer is prepared to pro-

vide a service and not reduce wages by its cost, then it will always be to the employee's benefit to receive the service even if they have to pay tax on its value. This can be easily illustrated. If the service has a value to a particular employee of \$3,000, and the employee is in the 33 per cent marginal tax bracket, the employee will have to pay \$1,000 of extra tax. Thus, he or she will have received \$3,000 of child care services for an effective cost of \$1,000. (If the employee can deduct the value of the services under the child care expenses deduction provision then, of course, the cost will be zero.) In this case, the cost of the child care services will either be paid directly by the employer in the form of lower profits, or if the employer shifts this cost forward in the form of higher prices, it will be paid indirectly by the consumers of the firm's products.

If, however, the employer pays for the services by reducing cash salaries, then the services will be paid, in effect, by all employees. Presumably, employees who will benefit from the service will still be better off since the tax they will have to pay on the benefit plus the amount by which their salaries will be reduced will be less than they would otherwise have to pay for child care services. On the other hand, employees who are not able to take advantage of the service will be worse off.

If the value of employer-provided daycare is not taxed as a benefit to employees, it is, of course, a very attractive form of remuneration. In effect, the government is subsidizing the service to the extent of the revenue lost because it is not collecting tax on the full value of the employee's remuneration. To avoid the problem that many employees may not be able to take advantage of this fringe benefit, employers sometimes offer what have been referred to as "cafeteria-style fringe benefit packages." Employees are provided the option of selecting which fringe benefit they wish to receive from a number of fringe benefits, such as recreational and educational training, memberships in clubs and daycare.

b) Incorporating a separate business corporate entity to establish and operate daycare facilities.

In order to keep the administration of the daycare services distinct from the employer's business operations, it may be convenient for the employer to incorporate a subsidiary corporation to provide the services. Although there might be good business and accounting reasons for pursuing this arrangement for establishing daycare facilities, the tax consequences will in almost every case make it an unattractive alternative for at least two reasons. First, the parent corporation's investment in the subsidiary corporation -- either in the form of a loan or equity investment -- will have to be treated as a nondeductible capital investment by the parent corporation. Consequently, none of the costs of establishing the child care facilities would be deductible to the employer. Second, if the subsidiary corporation providing the child care services operated at a loss -- as it likely would if employees are being subsidized at all -- the parent corporation could not deduct these losses from other income without winding up the subsidiary.

c) Incorporating a non-profit corporation to establish and operate daycare facilities

In most cases in which an employer wishes to get involved in establishing work-related daycare services the best alternative for it to follow, in terms of tax consequences, will be to establish a non-profit corporation and have it registered as a charity under the Income Tax Act.

A non-profit corporation can register as a charity if it is involved in the relief of poverty, religion, education or is providing a benefit to the community. A non-profit corporation providing child care services might register as a charity under either one of two of these grounds. Most commonly, the corporation would register as a charity on the grounds that it is providing a benefit to the community. Revenue

Canada has registered non-profit corporations providing child care services on this basis. However, in order to be registered on this basis the enrollment criteria may not favour the children of employees. Only if, in the Department's view, all children in the community are eligible to apply, can the non-profit corporation satisfy the requirement that it is providing a benefit to the community. Depending on the circumstances, this requirement may or may not be a problem to the employer. For example, even though all the children in the community are eligible to apply, geographical location or other circumstances may result in the services primarily benefitting employees. A non-profit corporation providing child care services could also register as a charity if it could show that it was engaged in educational activities. Even in this case, however, it would also likely have to be open to a wider group of children than simply children of employees.

A number of significant tax consequences flow from registering a non-profit corporation as a charity. Most importantly, the corporation will be able to issue receipts for all donations received. This could be an important advantage to the employer. Amounts paid to the non-profit corporation by the employer will be deductible in the year paid as charitable donations. Thus, even if the non-profit corporation uses amounts donated to it by the employer to build facilities or purchase appliances and playground equipment, these amounts will be deductible by the employer as current expenses. If the employer had incurred these expenses directly, they would have to be capitalized and amortized over future years. In addition, if the employer donates property, such as land, buildings, furniture and appliances (new or used), to the organization it will be able to deduct the fair market value of the property donated as a charitable donation. If the employer permits employees to contribute their services to the organization, for example, maintenance or secretarial assistance it will not be able to deduct the value of these services as a charitable contribution but it will be able to continue deducting the employees' salary as a business expense.

Taxpayers can only deduct up to 20 percent of their income in a year as charitable contributions. Thus, if an employer has little taxable income (or a loss) in a year it will not be able to deduct an amount contributed to a daycare organization. However, a tax change proposed in the November, 1981 budget will permit taxpayers to carry forward a charitable contribution in excess of 20 percent of their income for five years and to deduct it from income in those future years.

Not only employers but any interested person or organization will be able to make tax-deductible contributions to the daycare organization. Thus, the scope for fundraising is considerably broadened. Indeed, if the employer has established a private foundation to manage its charitable donations, the foundation will be able to establish and contribute to the daycare organization.

If a non-profit daycare corporation is registered as a charity under the Income Tax Act it will of course have to abide by the regulations in the Act for charities. In particular, the Act contains provisions to ensure that the organization is spending a certain percentage of its income on charitable activities (which would include the operation of a daycare centre) and requires it to file annual information returns. However, none of the requirements in the Act should cause any difficulty for a well-run daycare organization.

To the employee, the establishment of a non-profit corporation to provide daycare services should also have tax advantages. To the extent that the employer (and others) contribute to the non-profit corporation, child care services will be provided to the parents, including employees, at less than fair market value. This subsidy might be taxed to the employee as a fringe benefit if provided directly by the employer. However, since the facilities have to be open to all members of the public, employees who enroll children will not have received this benefit "by virtue of their employment" and therefore will not have to include any amount in their income as a taxable fringe benefit.

(d) Establishing a daycare facility in co-operation with other interested employers

In an industrial park or commercial complex a number of employers might join together to establish and operate a common daycare centre. By being able to attract children from a larger base of employees this arrangement has obvious non-tax advantages; in particular, it helps diminish the problem of fluctuating needs and promotes economy of size.

The employers might provide the services through a separate entity such as a business corporation or a non-profit corporation. The discussion above of the tax consequences involved when such entities are formed would apply equally in this situation. The non-profit corporation would in virtually all cases be the preferred vehicle.

An additional method by which a number of employers might provide child care services in co-operation with one another is a partnership. Although this method would seldom have any tax advantages over forming a non-profit corporation, it would in most cases be preferable to establishing a separate business corporation to provide the services. This is because under the Income Tax Act a partnership is not a taxpaying entity. Instead, the partnership profits or losses are divided among each partner and attributed to them for tax purposes. Thus, if the child care services suffered a loss in a year, which it invariably would do if the services were subsidized, each partner could deduct their respective share of this loss.

IV. ARRANGEMENT UNDER WHICH THE EMPLOYER DIRECTLY SUBSIDIZES EMPLOYEE CHILD CARE EXPENSES

If an employer does not wish to become involved in establishing a separate daycare facility for employees, or if such an arrangement is not feasible because, for example, employees work at a number of different

job locations, employers might undertake to directly subsidize or reimburse employees who incur child care expenses: they may simply provide employees with an accountable cash settlement if they have children under a certain age; they may provide vouchers to be used at child care centres; they may reimburse employees for some percentage of their expenses; or, they may make direct annual payments to child care centres in return for providing space to employees.

The tax consequences of these arrangements are straightforward. In all these cases the employer will be able to deduct the annual expenses in the year they are incurred as current business expenses. If the value of the benefit is easy to verify, employees will have to include it in their income as a taxable benefit.